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The Evolution of Sourcing Strategies

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A closer look at supply-side issues

Sourcing strategies in flux

Rising bulk wine prices, new trade agreements, and evolving market conditions are changing how wine is being sourced, and the impacts are being felt all along the value chain.

Rising bulk prices

Bulk wine prices continue to see a general upward trend across the globe, albeit with some exceptions. The impact is seen most notably in the more generic varietals.

M&A to remain dynamic

Industry consolidation continues, driven by many of the same forces as noted in the past—search for efficiency, diversification, etc. France has been particularly active, with both inbound and outbound activity.

US imports still rising

US wine imports continued their upward trend, with France and New Zealand driving bottled wine imports, and Australia driving success in bulk wine.

Shifting sourcing strategies in the global wine industry

2017 was an unusual one for the wine industry, forcing all players to rethink their short-term strategies given the rising prices and tighter availability. Although this may just be a one-off, it may also be enough to accelerate deeper changes that were already developing in the wine industry… And even to squeeze some players out of the market.

Drivers of change in sourcing strategies

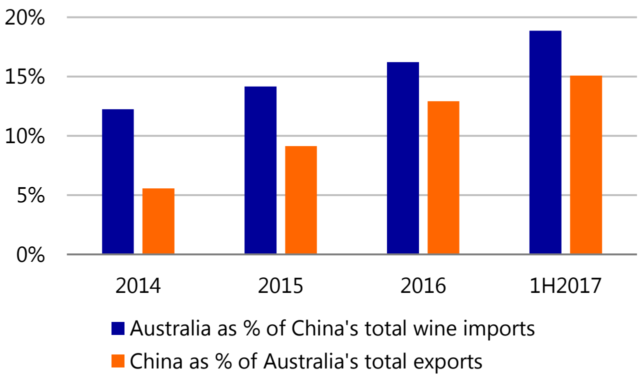
2017 was a dynamic year for the wine industry: in addition to the impact of changing consumer behaviour, global shifts in demand volumes, and changing trading frameworks, the industry is confronted with short-term challenges related to an unusual harvest in 2017. Some of these issues are temporary and unavoidable in the agricultural world. Others represent long-term structural changes, but short-term elements often accelerate long-term shifts.

Among the most important drivers of change in sourcing strategies are product scarcity, higher prices, changes in trade agreements, and changes in market conditions.

Higher prices. As a direct consequence of the tighter volumes, prices have increased. Grape buyers have already been hit by it and some wine buyers as well. But at the time of writing, most of the companies are negotiating deals for 2018, which is when the full impact of rising prices will spread along the value chain. For certain products, higher prices can be relatively easily transferred to the consumer. In other segments and markets, higher prices are likely to result in lower volumes. The different players along the value chain have to make choices, at least for the time being.

Trade agreements… and disagreements. The trade agreement between China and Australia, in place since 20 December 2015, is a clear example of how volume flows can be affected by such deals (*see Figure 1*). Other trade agreements, such as EU-Canada CETA, signed in September 2017, and the EU-Japan agreement, signed in December 2017, will shape up future flow. More importantly, given the size of the market, the final outcome of the Brexit negotiations will also shape future global wine flows.

Figure 1: Impact of trade agreement on Australia's wine exports to China



Source: Wine by Numbers, UIV, 2017

Changes in market conditions. China has become the fifth-largest wine importer in the world and has consolidated its position as a major actor in the global wine trade. Operators in the country have gained knowledge and experience and are more confident in the business. As a result, the number of intermediaries between producer and consumer is declining. A similar trend is observed in other countries, such as Russia.

As a result of all these factors, wineries and wholesalers are not only changing the way they sell their wine but also their sourcing process. The specific strategies followed depend on the position of the individual player and its particular vision of the longer-term outlook, but certain patters are becoming clear.

Short-term strategies: Evaluating availability and costs

The short-term scarcity and rising prices have affected grape and must buyers (thus wineries, who already have been confronted with higher input prices) and bulk wine purchasers looking to buy large amounts at relatively low prices for their own blends or brands.

From the perspective of many growers, higher prices and easy-to-place volumes may bring temporary relief but do not change their challenged strategic position. For others, higher prices may not be enough to offset lower production.

With inventories acting as a buffer and the young European wines just beginning to come to the market, the full impact along the value chain will only be felt in 2018.

Confronted with the specific situation of this season, buyers looking to purchase bulk wine have followed different strategies. Some have minimised their purchases, betting on a price reduction in the spring when the southern hemisphere harvest materialises. But a number of producers indicate that the percentage of their total production pre-sold at this stage is higher than that of other years, suggesting that although buyers may have initially postponed their purchases, many have finally chosen not to wait. Some purchasers have just bought less, assuming they will be selling less as they pass on higher prices to their customers.

Other players, on the contrary, have acquired even larger than usual amounts from their suppliers, despite higher prices. This strategy reflects the view that prices are unlikely to come down at least until the 2018 northern hemisphere harvest is closer. They are concerned about limited availability later in the year and a wish to secure a product that they are confident to sell.

Higher-priced wine producers have also been severely hit in 2017, but the segment as a whole benefits from some mitigating factors. These players have greater facility to pass on price increases, and the maturing of stocks for several years dilutes the impact of one bad harvest. However, some wineries will not have enough product this year to maintain the usual allocation to their clients, who in turn will have to look elsewhere for product to fill their shelves/catalogues.

Longer-term strategies

None of the changes in long-term strategies are new or triggered by one poor harvest –which all industry players admit is a natural occurrence in the industry. However, the recent events confirm their validity and are likely to accelerate and reinforce their implementation.

Wineries: Investing in vertical integration, diversification

A number of wineries, confident about the demand outlook for higher quality/higher value wine, are increasing their own supply autonomy by planting vines (where regulation allows) or buying vineyards. With this they seek to minimise input cost volatility and to secure enough supply.

Other producers are seeking to diversify their offer (and their risk) by trading up into higher added value wines (from purchased grapes/musts) or expanding into other DOCs/geographies/countries, frequently through acquisition of existing businesses. The Chilean market, for instances, has seen increasing interest from Chinese, Argentine and Spanish buyers, among others.

Also at the higher end of the market, investor appetite is high. In the most prestigious French AOC, there is a sustained interest from domestic and international buyers. In this case, besides the potential return on the investment from the wine revenues (sometimes questionable, given the prices paid), there is a status associated with the deal and the potential profit from the future sale of the property.

But the rise in grape prices of 2017 should not let us forget that it comes after several years of modest or nil rises. This in turn has led to underinvestment at a number of wineries across the world. In some regions, vines are being replaced by other crops. One year of price recovery is most likely not enough to make these operators reinvest- especially where higher prices have not been enough to offset the loss in volumes- which may make this a good occasion to cash in.

Retailers: fewer intermediaries, more diversification

In recent years, it has become increasingly common to see retail groups purchasing directly from producers. In some cases, they buy bulk wine directly in a producing country and subcontract bottling capacity in their domestic market. Even if they still use a middle-man, at the very least, they personally visit the wineries and test the product. By moving closer to the producers, purchasers have greater control over the entire process and reduce the costs of intermediation.

This trend is not exclusive to the large buyers in well-established wine consuming countries. The Chinese market, for instance, has reached a new stage and its participants have a much more professional knowledge of wine. As a result, they are reducing the number of intermediaries used in the process and buyers are becoming more critical and demanding.

Buyers are also showing greater interest in diversifying beyond the mainstream origins and wines. Wines from lesser-known regions in established markets, such as certain Eastern European countries, for instance, are gaining shelf presence in Western Europe. This growing interest for lesser-known regions is consistent with consumer appetite for more niche products with an authentic background. It also helps sellers (in particular on trade, speciality shops and online retailers) to differentiate their offering from the mainstream. While 2017 was a year of scarce production in France, Spain, and Italy, it was a relatively good year in Eastern Europe. The number of Eastern European wines on the shelves of Western European retailers and restaurants will likely see a notable increase in 2018.

Wholesalers and distributors changing business model

A number of structural shifts are changing the role of wholesalers and other intermediaries in the wine industry. A growing number of retailers and ultimate sellers are entering into direct contact with the producers, either buying directly or personally testing and selecting wines at the cellars. These changes force intermediaries to review their business model if they want to keep adding value to their customers. Wholesalers are, for instance, increasingly developing their own brands on the basis of bulk imported wines. Consolidation among wholesalers in order to gain economies of scale that enable them to offer more attractive deals to their customers is also an ongoing trend.

Implications for the industry

All the trends above suggest that, in the near future, the wine industry will continue to see sustained M&A activity all along the value chain. For that reason, a number of players will increase the amount of capital tied up in the business. Other players, not willing or able to follow such trends, are likely to reconsider their future.

M&A market to remain active. Four major drivers will maintain the dynamism of M&A activity in the wine industry. On the buying side, the appetite of wineries to build up scale and diversify—the desire to secure access to supply by different players along the value chain—and the need for wholesalers and distributors to change their business model and expand their activities.

On the selling side, and in addition to the other classic reasons in the industry (such as generational changes), the new operating environment is likely to encourage a number of players to reconsider their viability as standalone businesses.

Growing capital requirements. Working capital in the shape of payables and stocks is likely to increase in the near term for virtually all producers due to higher input costs. At certain times, the situation gradually shifts to wholesalers and retailers. For the players aiming to scale up the quality of their product, this rise in working capital investments becomes a structural situation.

The higher value of grapes and wine results in a larger working capital load at the balance sheet of all producers (inventories and account payable increase). Eventually, the same will apply to wholesalers and retailers as they buy the goods. Even if this may be a short-term situation, it needs to be funded and may represent a problem for companies with an already tight balance sheet structure.

At the same time, those players that want to trade up into higher quality wines will need to find funding solutions for structurally higher working capital positions.

Winery M&A

Global wine M&A summary for Q4 2017

The wine M&A market remained very dynamic in the last months of the year, involving both Old and New World wineries. The strategic drivers behind the deals seen since September are similar to those observed earlier in the year—domestic consolidation in producing countries, international diversification, and inflow of money from outside the industry. Portfolio restructuring and private investors/ families exiting the business have provided the targets.

France in the spotlight. France has been a very dynamic market, as the largest players consistently expand their business inside and outside the borders: Guigal and Jadot have added new 'domaines' to their portfolio; Grand Chais de France has bought Germany's Binderer St. Ursula, until now a privately owned importer, blender, and distributor with a strong presence in Germany and Hungary; LVMH has bought a 60% stake in Napa's Colgin Cellars; and Thienot has reiterated its international appetite after taking a stake in L'Aventure Winery, also in the US. The most prestigious areas in France have also seen a number of highly visible deals, such as the acquisition of Clos de Tart (Grand Cru Monopole, Burgundy) by Artemis (the investment vehicle of the Pinault family), and the purchase of Château Berliquet by the Wertheimer Brothers, who already own other wineries but whose largest business is the luxury brand Chanel. And, despite higher restrictions to investing abroad, Chinese investors remain enthusiastic buyers of French Chateaux, as the purchase of Chateau de Beauregard and Chateau des Noyers, by businessman Yue Xu or the acquisition Chateau Bellefont-Belcier, by Peter Kwok evidence.

Global trade

Export trends of major producers

France

Exports of French wine during the August to October period increased by 9.7% in volume and 8.9% in value over the same period of the previous year. Sparkling wines (exc. Champagne) saw a particularly strong performance, up by 19% in volume terms. French still wine without GI also benefited from double-digit growth (+14%) in volume terms, in part due to rising bulk exports. Exports of AOP wines were up by 9%. Only re-exports of non-French wines (15% of total exported volume) and those with more than 15% alcohol (marginal) contracted. Average export prices were stable for Champagne, sparkling, and AOP wines, but declined for French still wines with or without GI. Exports to China and the US were particularly strong. Exports to the EU also increased but lost further weight as share of total exports.

Italy

In 2017, Italian wine exports increased by 7% to EUR 6bn. The increase was supported by a 47% increase in exports to Russia and 25% to China, albeit with lower volumes in absolute terms. Exports to the UK increased by 8% despite headwinds related to Brexit. Sales to the US, the largest market in value terms, were up by 6%, and Germany, despite a modest 3% increase, remains the second-largest market for the Italian wines. Sparkling wines were the best performing segment, with exports up by 15% to EUR 1.2bn.

Spain

In the first ten months of the year, Spanish wine exports increased by 3.9% in volume and 7.5% in value terms. Volume growth was driven by larger exports of still and sparkling bottled wine as well as by varietal bulk wine exports. All other bulk wine exports contracted in volume terms, although the export price per litre increased across-the-board, resulting in an average price increase of 16% for bulk and 4.3% for bottled wine.

US

US wine exports saw a decline of 7% in volume and 11% in value for the nine months ending September. Bottled exports, particularly to the EEC and Canada, led the decline. Exports of bulk wine saw a mild improvement, rising 3% in volume and 8% in value, but was not enough to offset the decline in shipments of bottled wines.

Table 1: Change in wine exports for selected countries, YTD 2017

Country	Volume change (%)	Value change (%)*	Period of measure
France	9.7	8.9	Aug-Oct
Spain	3.9	7.5	Jan-Oct
Italy	n.a.	7.0	Jan-Dec
US	-7.0	-11.0	Jan-Sept
Argentina	-13.7	-1.6	Jan-Oct
Chile	6.8	7.6	Jan-Nov
South Africa	4.7	N/A	Jan-Dec
Australia	9.0	13.0	Oct-Sept

*Value changes in local currencies, Argentina and Chile in USD.

Source: Wine Australia; Gomberg, Fredrikson & Associates; Observatorio Vitivinícola Argentino; SAWIS; Oficina de Estudios y Politicas Agraria de Chile; New Zealand Winegrowers 2017

Argentina

During the first ten months of the year, wine exports declined by 13.7% in volume and by 1.6% in value (excluding musts exports, which saw a decline of over 40% in volume terms). This is 7.2% when compared to the same period of 2016. Bulk wine exports experienced a 40% decline in volume terms, with bottled wine volumes down by 7%.

Chile

In the first eleven months of the year, Chilean wine exports increased by 6.8% in volume and 7.6% in value terms. This performance reflects growing sales to China (+30.7% in volume), Brazil (+16.4%), and Japan (+12.1%), while exports to the US contracted.

South Africa

In 2017, total wine exports increased by 4.7% in volume when compared to 2016, with bulk wine up by 5.7% and packaged wine up by 3.2%. White wine (+6%) outperformed red wine (+1%), although exports of certain varietal red wines (Cabernet Sauvignon, Shiraz, Pinotage, Merlot) saw double-digit increases. Exports to the UK, the largest importer of South African wine (23% of total South African exports) increased by 9%. It is worth noting that exports to the US increased by 145% in the year.

Australia

In the 12 months to September 2017, Australian wine exports grew by 13% in value and 9% in volume when compared to the previous year. Exports grew at all price points, but in particular for wines below AUZ 2.5 per litre and above AUZ 20 per litre. By country, sales to Greater China continued to be a key driver, with a 42% YOY increase in value terms. These could more than offset lower sales to the UK, New Zealand, or Canada.

US import trends

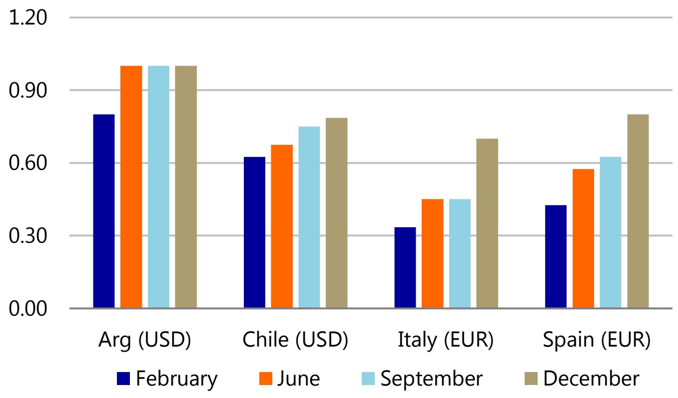
US wine imports rose 9% in volume and 8% in value in the first nine months of 2017, compared to the same period in the prior year, according to the most recent Gomberg-Fredrikson Report *(see Table 2)*. According to the report, all growth in US wine consumption for the first nine months of 2017 was driven by imports, as California shipments to the US were flat, while imported bulk shipped by US wineries was up 23%, and bottled imports rose 4%.

Table 2: US imports by country of origin, Jan-Sept 2017

	Value (USD million)	Change (%)	Volume (thousand cases)	Change (%)
Italy	1,397.5	3	28,800.0	3
France	1,334.6	18	13,751.3	17
Spain	277.0	4	7,700.0	15
Australia	294.4	2	14,732.9	28
New Zealand	203.4	9	3,959.8	20
Chile	206.9	-1	11,301.3	-14
Argentina	231.0	-4	5,900.0	-13
Portugal	69.9	10	1,571.7	11
World total	4,485.4	8	107,340.0	9

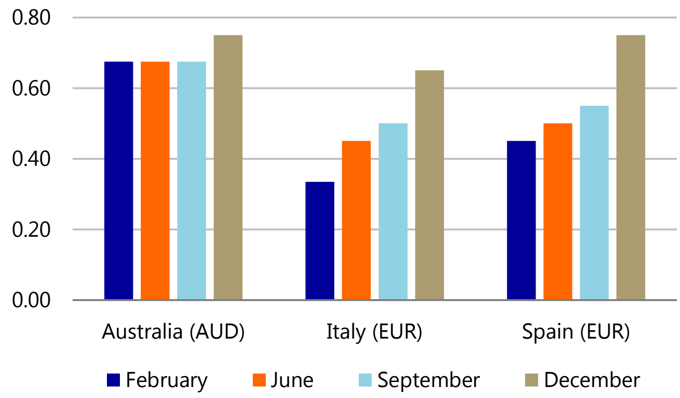
Source: The Gomberg-Fredrikson Report 2017

Figure 2: Prices for generic red bulk wine by country of origin and currency, Feb-Dec 2017 (price per litre)



Source: Ciatti Company 2018

Figure 3: Prices for generic white bulk wine by country of origin and currency, Feb-Dec 2017 (price per litre)



Source: Ciatti Company 2018

Italy continues to be the largest supplier of imported wine in the US, generating twice as much volume as the next closest competitor. Imports from Italy rose 3% in volume and value in the period, led by growth of prosecco (12%), vermouth (6%) and bulk wines (11%).

Imports from France rose 17% in volume and 18% in value. The growth is led by bottled table wines, reflecting the ongoing demand growth for French rosé.

Imports from Australia rose 28%, as the 8% decline in bottled wine imports was more than offset by a 124% increase in shipments of bulk wine.

Imports from New Zealand rose 16% in volume and 12% in value, mainly reflecting the rapid shift away from bottled towards bulk wine imports.

Import volumes from Spain rose 15%, mainly driven by the 198% increase in shipments of bulk wine.

Chile saw volume sales to the US decline by 14%, with declines in shipments of both bottled (-1%) and bulk (-21%).

Bulk wine pricing

The impact of the short harvests in Europe and parts of the southern hemisphere continue to be felt, with upward pricing pressure noted across numerous regions and varietals.

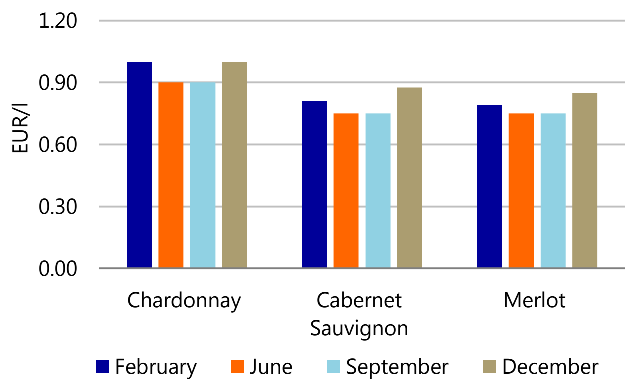
The most notable impact is being felt at the lower end of the market, as seen in the pricing trends for generic reds and generic whites across numerous regions (see Figures 2 and 3).

While price increases are apparent across numerous varietals and countries, particularly in Europe, a key exception is France, where pricing has remained largely stable (see Figure 4). This seems to be due to the fact that France focuses more on higher value varietals than on generic wines, and the prices for French varietals appear to be setting a ceiling on pricing for similar varietals from other suppliers.

Currency outlook

Measured from early December into early January, the Australian dollar was the second best performing G10 currency after the New Zealand dollar, supported by rising expectations of an RBA rate hike in 2018. Following the release of strong November labour data, August is being cited more frequently as a potential date for a 25 bp increase in rates. Since a lot of good news is now in the price, if AUD/USD is to progress further, the next round of domestic economic data releases will likely have to be sound. However, with wage inflation low and given the potential for slowing Chinese demand for bulk commodities there is no pressing reason for the RBA to hike rates aggressively and we retain a relatively cautious medium-term view on the AUD vs. the USD. While we see scope for a fairly flat range for AUD/USD through the

Figure 4: Prices for French bulk wine by varietal, Feb-Dec 2017 (EUR per litre)

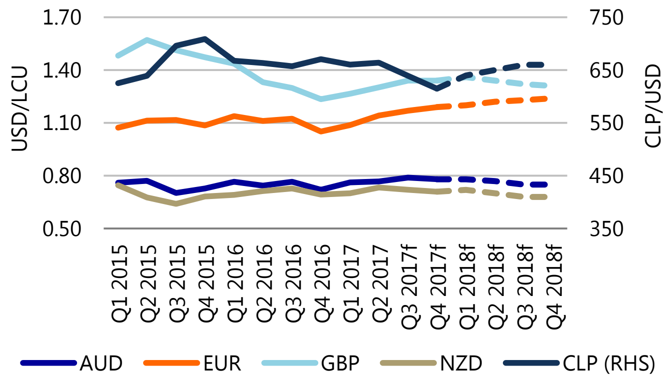


Source: Ciatti Company 2017

coming six to eight months, we continue to see scope for a softer AUD/USD into year end.

In Europe, sentiment on the EUR was buoyed at the very start of January by another round of good Eurozone economic data. Although ECB President Draghi maintained a dovish tone at last month's ECB policy meeting, speculation that the central bank could signal its will to back out of QE later in the year is likely to remain a key influence on the euro through 2018. At the same time, optimism that a Brexit transition period will be confirmed has helped to support the pound. However, looking ahead, EU/UK trade talks are likely to be tough and could expose cracks in PM May's cabinet *(see Figure 5)*.

Figure 5: Wine currency movements and forecasts Q1 2015-Q4 2018f



Source: Bloomberg, Rabobank 2017

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